IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

NEUBERGER and SCOTT	:	CIVIL ACTION
	:	
v.	:	
	:	
WILLIAM SHAPIRO, ET AL.	:	No. 97-7947

O R D E R

And Now, this 9th day of July, 1998 the four motions to dismiss of (1) defendants William Shapiro, Kenneth Shapiro, Lester Shapiro, Nathan Tattar, Welco Securities, Inc., Shapiro P.C.; (2) defendant R.F. Lafferty & Co.; (3) defendant Cogen, Sklar, L.L.P.; and (4) defendants John Orr and Adam Varrenti are denied, excepting as to the issue of pleading fraud with particularity, which is granted. See, by analogy, the heightened pleading standards for fraud actions under the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4(b).[1]

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Edmund V. Ludwig, J.

[1] This state claim, intentional misrepresentation, upon announcement of the substance of this Order in open court, was withdrawn by plaintiffs.

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M E M O R A N D U M

Ludwig, J. **July 17, 1998**

This memorandum follows an order entered July 9, 1998 denying defendants' motions to dismiss the complaint, excepting as to the issue of pleading fraud with particularity, which was granted.[2]

The complaint sets forth securities law violations relating to plaintiffs' purchase, in 1996 & 1997, of debt certificates issued by the Equipment Leasing Company of America (ELCOA). According to the complaint, the securities were purchased in reliance on materially false and misleading prospectuses and registration statements by ELCOA and its parent company, Walnut Leasing, Inc. Complaint ¶ 1. The individual defendants in the action are former officers or directors, or both, of ELCOA or Walnut Leasing. The corporate defendants include two broker/dealer firms (Welco Securities, Inc. and R.F. Lafferty & Co.); an accounting firm (Cogen, Sklar, L.L.P.); and a law firm ("Shapiro

[2] This state claim of intentional misrepresentation, upon announcement of the substance of this order in open court, was withdrawn by plaintiffs.

P.C.") - each of which in some way is alleged to have assisted in the sale of the certificates.

Count 1 specifies violations of § 11 of the Securities Act of 1933, 15 U.S.C. §§ 77k, by individual defendants[3] and the "Shapiro Entities";[4] count 2, by the remaining defendants; count 3, violations of § 15, 15 U.S.C. §§ 77o, by the individual defendants and the Shapiro entities; and counts 4 and 5, negligent and intentional misrepresentation by all defendants.

The four dismissal motions are substantially the same. Fed.R.Civ.P. 9(b), 12(b)(1),(3),(6),(7), 19 & 23. With one exception, each attached exhibits.[5] Upon consideration of all of the grounds raised, the motions will be denied, other than as to count 5, which has been withdrawn.

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[3] William Shapiro, Kenneth Shapiro, Lester Shapiro, Nathan Tattar, John Orr, Adam Varrenti, Jr. See complaint ¶ 19. John Does 1-25 are also included as "individual defendants."

[4] Welco Securities, Inc., William Shapiro, Esq., P.C. See complaint ¶ 92.

[5] The Shapiro defendants' motion attached 12 exhibits, R.F. Lafferty attached the "fairness opinion" prepared by it for the ELCOA offering; and the motion of defendant Cogen, Sklar included color graphs and charts, and attached an appendix containing 12 exhibits. Our Court of Appeals has stated that on a motion to dismiss, only the complaint "and the documents on which the claims made therein were based" if not disputed may be considered. In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1424-25 (3d Cir. 1997); see also In re Donald J. Trump Casino Securities Litigation, 7 F.3d 357 (3d Cir. 1993) (when prospectus is directly at issue in a complaint, it may be considered on a motion to dismiss). Here, the complaint challenges the "Offering Materials," which include "prospectuses, registration statements, and other documents." Complaint ¶ 1. Therefore, those documents are regarded as within the scope of the motions. See order of June 19, 1998.

A. Fed.R.Civ.P. 12(b)(1)

The Shapiro defendants assert that the subject matter of this action is within the jurisdiction of the Bankruptcy Court, ELCOA having filed, in this district, a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Shapiro motion at 2. The motion characterizes plaintiffs' claims as "core proceedings" within the meaning of 28 U.S.C. § 157(b)(2). Id. at 8-9.[6]

Caselaw describes a "core proceeding" as one that implicates a substantive right created by the Bankruptcy Code or one that would arise only in bankruptcy; not all claims "related to" the administration of bankruptcy estate are "core proceedings." See In re Continental Airlines, 125 F.3d 120, 131 (3d Cir. 1997); Hays and Company v. Merrill Lynch, 885 F.2d 1149, 1157 n.9 (citations omitted). Here, plaintiffs' claims are not attributable to the Bankruptcy Code and, therefore, are not "core proceedings."[7]

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[6] Neither ELCOA nor Walnut is a defendant in this action.

[7] The motion of the Shapiro defendants relies on Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984) for the proposition that a civil action brought by a third party, not directly involving the debtor, is "related to" the bankruptcy action when "the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy." Motion at 5. Pacor goes on to state, however: "On the other hand, the mere fact that there may be common issues of fact between a civil proceeding and a controversy involving the bankruptcy estate does not bring the matter within [bankruptcy jurisdiction]." Instead, the effect that the resolution of the civil proceeding would have on the bankruptcy estate is the key inquiry. Where the outcome would "determine any rights, liabilities or course of action of the (continued...)

To the contrary, subject matter jurisdiction over this action exists in this court under 28 U.S.C. §§ 1331 and 1367.

B. Fed.R.Civ.P. 12(b)(3)

A related argument is that, because the Bankruptcy Court has jurisdiction over the bankruptcy, venue is not proper here. This assertion is unsupportable. According to the complaint, "substantially all of the events, statements, and omissions giving rise to the claims...occurred in this district." ¶ 6. This allegation sufficiently establishes proper venue.

C. Fed.R.Civ.P. 12(b)(6)[8]

Plaintiffs' complaint asserts four separate grounds for relief.

1. Counts 1-2 - Section 11 of the Act ("Civil liabilities on account of false registration statements"):

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[7](...continued)
debtor," the action is "related to" bankruptcy. Pacor, 743 F.2d at 995. Examples given in Pacor are the existence of an indemnification agreement or other contractual guaranty between the third party and the debtor. Such an agreement is not present here: the analysis is consistent with Pacor.

[8] "A complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Conley v. Gibson, 355 U.S. 41, 45-46, 78 S. Ct. 99, 101-02, 2 L. Ed.2d 80 (1957); Weiner v. Quaker Oats Company, 129 F.3d 310, 315 (3d Cir. 1997). In so doing, all factual allegations of the complaint must be accepted as true and all reasonable inferences drawn in Plaintiffs' favor. Quaker Oats, 129 F.3d at 315.

> [A] plaintiff must allege that he "acquired" a security which was accompanied by a registration statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein "not misleading." 15 U.S.C. § 77k(a) (1988). Plaintiffs need not allege reliance, scienter or damages, though they must allege that the shares they purchased are traced to a false or misleading registration statement.

In re Chambers Development Litigation, 848 F. Supp. 602, 616 (citing In re Westinghouse Securities Litigation, 832 F. Supp. 948, 966 (W.D. Pa. 1993), aff'd in part, rev'd in part on other grounds, 90 F.3d 696 (3d Cir. 1996)). Here, the complaint states that plaintiffs were purchasers of ELCOA certificates "pursuant to the prosectuses and registration statements." Complaint ¶22. This satisfies the "traced to" requirement. The complaint also outlines the alleged misrepresentations contained in the prospectus, financial statements included in the prospectus, the audit report, and subsequent filings with the S.E.C. ¶¶ 39-79. These allegations of purported misrepresentations constitute a sufficient statement of material facts.[9]

Cogen, Sklar and the Shapiro defendants challenge the "materiality" of the alleged misrepresentations. See Motion of Cogen, Sklar at 3-8. Their argument is that the offering materials disclosed all the risks inherent in the offered securities. Ergo, the "misrepresentations" averred cannot be said, as a matter of

[9] For example: the intended use of proceeds derived from the sale of securities, ¶¶ 40-42; and the viability of ELCOA's parent company, Walnut Leasing (material misrepresentations concerning the makeup of the board of directors of the offeror and its parent; material misrepresentations concerning the "risk factor" disclosure), ¶¶ 42-44.

law, to have been "misleading" within the meaning of section 11.[10] Caselaw supports the principle that "where...the accompanying statements plainly reveal that which was allegedly 'concealed,' the alleged misrepresentations are manifestly immaterial to plaintiff's claims and must be dismissed as a matter of law." Id., n.8 (citing cases).

While it is true that certain risks were disclosed in the prospectus, see "Risk Disclosures," at pages 1-11, the complaint also alleges misrepresentations and omissions of "material facts ... necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). There are four groups of such misrepresentations in the complaint. The first concerns the "use of proceeds" of the September, 1995 offering. According to the complaint, although the prospectus at page 8 states that "the proceeds of this offering will not be used to meet redemptions of Debentures previously issued," such misuse had already occurred. Complaint ¶ 40. The second concerns the interdependence of Walnut and ELCOA, including the independent financial viability of each. According to the plaintiffs, the prospectus was materially misleading when at page 8-9 it stated that "Walnut does not finance the operations of ELCOA, ELCOA was not inadequately capitalized, each entity pays its

[10] "In short, irrespective of any alleged misrepresentations in the financial statements themselves, a reader of ELCOA's 1995 prospectus (and ELCOA's other SEC filings) was fully advised of Walnut's financial difficulties, ELCOA's dependence on Walnut, ELCOA's policies and difficulties with regard to lease collections and delinquencies, and that there was 'substantial doubt' regarding ELCOA's 'ability to continue as an ongoing concern.'" Cogen, Sklar motion to dismiss at 5.

own operation expenses and maintains separate books and records, and the formal requirements of separate and independent corporate existence are observed." Complaint ¶ 43. This statement is alleged to have been "false when made" as "the boards of both companies were interlocking." Complaint ¶¶ 44. Moreover, according to the complaint "the risk factor disclosure was materially false and misleading in that it failed to disclose the then existing fact that Walnut was functionally bankrupt which meant that ELCOA was likewise insolvent." ¶ 45.

Third, according to the complaint, the financial statements included in the prospectus are alleged to have misrepresented ELCOA's assets. One instance - the April 30, 1995 balance sheet shows 14 percent of ELCOA's total assets were in the form of a "receivable" from Walnut of nearly $4 million. ¶¶ 47-48; prospectus at 44. According to plaintiffs, both the value and the use of the receivable were misrepresented: "defendants used this representation to imply that the advances from ELCOA to Walnut were for legitimate business purposes of ELCOA. In fact, the advances were solely to support Walnut." Complaint ¶ 49. Moreover, according to plaintiffs "the Walnut Receivable was not really a loan, but rather constituted illegal dividends in excess of the accumulated earnings of ELCOA. The misrepresentation of these advances as a loan is clearly more than an improper estimate of loss reserve." Plaintiffs' sur-reply at 6.

Last, the audit report is challenged. Complaint ¶¶ 56-69. For example, "defendants used a 'Risk Disclosure' to obscure

the fact that filing for bankruptcy by Walnut would leave ELCOA insolvent." ¶ 59. If true, these assertions, whether affirmations or omissions, constitute material misrepresentations.

The motion of defendant Cogen, Sklar also raised the bar of the Securities Act's limitations period. Claims must be brought "within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence... In no event shall any such action be brought...more than three years after the security was bona fide offered to the public." 15 U.S.C. § 77m.[11]

Here, in 1996 and 1997, plaintiffs purchased certificates that were offered in a September 14, 1995 prospectus.[12] Complaint ¶¶ 7-8; mem. in opp. at 4. It is alleged that the complained of misrepresentations were not discovered until shortly after August 8, 1998 - the date when ELCOA filed for bankruptcy protection - thereby triggering the "discovery rule" prong of the statute. On December 23, 1997 this action was filed. It therefore appears that the complaint was timely filed - within three years from the September 14, 1995 offering, as well as within one year of plaintiffs' discovery of their claims. Moreover the complaint is

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[11] The motion asserts that the complaint is deficient because it does not plead compliance with the statute, a substantive element of plaintiffs' § 11 claim. See motion at 21. This assertion is incorrect. The complaint affirmatively pleads compliance with the statute of limitations in paragraphs 85 and 91.

[12] Plaintiffs' memorandum in opposition at 22 states that the certificates were issued in a rolling offering. The start-and-end dates of the offering are not specified.

not subject to dismissal under the equitable doctrine of laches. See motion of Shapiro defendants at 20.

All defendants are properly named under § 11. The Shapiro defendants and defendants Orr and Varrenti are named as "director[s]...at the time of the filing of the part of the registration statement," 15 U.S.C. § 77k(a)(2); corporate defendants Cogen, Sklar, Shapiro P.C. and R.F. Lafferty are alleged to have "prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement," § 77k(a)(4); and defendant Welco Securities was the underwriter, § 77k(a)(5). W. and K. Shapiro also are alleged to have signed the registration statement, making them proper defendants under § 77k(a)(1). See plaintiffs' motion in opp. at 27.

2. Count 3 - Section 15 of the Act ("Liability of controlling persons"):

> Every person who, by or through stock ownership, agency or otherwise ... controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable...

15 U.S.C. § 77o.

As noted, count 3 alleges that the individual defendants and the "Shapiro entities" violated section 15 - control

liability.[13] Accepting as true the allegations that each of the individuals was an officer or director, or both, of ELCOA, each would have been in a position of potential control over the company when it released its offering materials. ¶¶ 9-14. The complaint also adequately asserts that each of the corporate defendants that comprised the "Shapiro entities"[14] was controlled by the individual Shapiro defendants and, as such, operated as an "alter ego" vis-a-vis ELCOA or Walnut. ¶¶ 15, 18. Given these allegations, whether or not each individual or corporate defendant exercised actual "control" sufficient to impose liability under this section presents questions of fact that cannot be resolved at the pleading stage. See In re Chambers Development Securities Litigation, 848 F. Supp. 602, 618 (W.D. Pa. 1994).

3. Counts 4-5 - Negligent and intentional misrepresentation: The elements of negligent misrepresentation are found in the Restatement (Second) of Torts § 522 (1977) -

> One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

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[13] Defendants R.F. Lafferty and Cogen, Sklar are not named in Count 3 - control liability.

[14] Welco Securities, Inc., Shapiro P.C. Complaint ¶¶ 15, 18.

See Eisenberg v. Gagnon, 766 F.2d 770, 778 (3d Cir.), cert. denied 474 U.S. 946 (1985) (Pennsylvania Supreme Court adopted Restatement (Second) of Torts § 522 as statement of claim of negligent misrepresentation). Liability is limited by privity and reliance requirements.

Defendant Cogen, Sklar maintains that privity was lacking between it and plaintiffs. The reason given is that plaintiffs were not a "limited group of persons for whose benefit and guidance" the information was intended. "[B}ecause ELCOA Certificates were marketed and available to the public at large, it would entirely eviscerate the privity requirements of Pennsylvania law to hold that all members of the investing public, as potential investors ... constitute a 'limited group'...." Reply memorandum at 12.[15]

This argument was rejected in In re National Media Securities Litigation, No. 93-2977, 1994 W.L. 397398, *6 (E.D. Pa. 1994) (Padova, J.). There, the complaint averred reliance by plaintiffs on publicly available information. Id. The decision reasoned that such reliance was "appropriate" because the "securities laws impose a duty to disclose accurate information, and investors are the class of people for whose benefit that obligations exists." Id. This rationale is applicable here, where plaintiffs are alleged to have sustained damages because of

[15] While Cogen, Sklar argues the privity issue only as to itself, the argument would also apply to all defendants because it focuses on how the securities were sold - to the public at large - not each defendant's specific role in that sale.

misrepresentations appearing in publicly available registration materials. Specific questions of fact remain as to the requisite privity relationship of each defendant; they cannot be resolved on motions to dismiss.[16]

Defendant Lafferty, the broker/dealer who prepared the "Fairness Opinion" - upon which the 1995 registration materials was based - asserts that because the review was performed in 1993, plaintiffs' claim of reliance is untimely as a matter of law. Motion at 3. The logic of that proposition is questionable and is not illuminated by any caselaw. In any event, reliance issues present fact questions inappropriate for resolution at this stage.

D. Fed.R.Civ.P. 12(b)(7) and 19

The motion of the Shapiro defendants states that ELCOA and Walnut are indispensable parties, for which reason the action, without them, must be dismissed. Motion at 16. This contention is not supported by authority. Indeed, § 11, which lists the parties who may be held liable under its provisions, does not include the issuer. See 15 U.S.C. § 77k(a)(1)-(5) (The following may be sued: every person who signed the registration statement; every director or partner in the issuer at the time of filing; every person who consented to be a director or partner; every accountant, engineer,

[16] The motions of defendants R.F. Lafferty and Orr and Varrenti each contain a variation of this argument - stating that the complaint does not set forth the allegations necessary to establish privity as to them. Lafferty motion at 3; Orr/Varrenti motion at 2.

or appraiser, or any other professional who has consented to take part in preparation of the filings; every underwriter of the securities).[17]

E. Fed.R.Civ.P. 23(b)

The motion of the Shapiro defendants challenging the complaint's "class action allegations," motion at 12-13, will be deferred until a filing for class certification.

F. Fed.R.Civ.P. 9(b)

Arguing that plaintiffs' claims make allegations of fraudulent conduct, defendants point to the heightened fraud pleading requirements of Rule 9(b) - "all averments of fraud ... shall be stated with particularity." As a threshold matter, Rule 9(b) is not applicable to claims under § 11 claims - misrepresentation - unless they "sound in fraud." Shapiro v. UJB Financial Corp., 964 F.2d 272,287-288 (3d Cir. 1991); see also In re Phar-Mor, Inc. Litigation, 848 F. Supp. 46, 50 (W.D. Pa. 1993); Constitution Reinsurance Corp. v. Stonewall Ins., 872 F. Supp. 1247, 1246 (S.D.N.Y. 1995); In re Compaq Securities Litigation, 848 F. Supp. 1307, 1312, n.11 (S.D. Tex. 1993). Here, unlike UJB

[17] Moreover, since the complaint alleges that William Shapiro is the sole shareholder of Walnut Associates and that Walnut Associates is the sole shareholder of Walnut, which is in turn the sole shareholder of ELCOA, plaintiffs have pleaded a claim under § 15, control liability. See complaint ¶ 9.

Financial Corp., the complaint makes no mention of intentional or reckless violations of the securities laws. Instead, it uses such language as "the Individual Defendants knew or, in the exercise of reasonable care, should have known of the material misstatements and omissions contained in the Offering Materials....None of the Individual Defendants made a reasonable investigation or possessed reasonable grounds for the belief that the statements...were true...." These are averments of negligence, typical of securities law claims.

As pleaded, Count 5, intentional misrepresentation, is a state common law fraud claim. The elements are: 1) a material misrepresentation; 2) an intention to deceive; 3) an intention to induce reliance; 4) justifiable reliance by the recipient upon the representation; 5) damage to the recipient proximately caused by the misrepresentation. Step-Saver Data Systems, Inc. v. Wyse Technology, 939 F.2d 91, 106 (3d Cir. 1991). As noted, this claim was deficiently pleaded and has been withdrawn.

Edmund V. Ludwig, J.